INDEX

	Page
Opinions below	2
Jurisdiction	2
Questions presented	2
Statute involved	3
Statement	5
Argument	6
Conclusion	14

CITATIONS

Cases:

Cohen v. *Saddlemire*, 26 F. Supp. 27	12
Continental Illinois National Bank & Trust Co. v. *Chicago, Rock Island & Pacific Ry. Co.*, 294 U. S. 648	12
Hague v. *C.I.O.*, 307 U. S. 496	12
Mar-Tex Realization Corp. v. *Wolfson*, 145 F. 2d 360	12
Meinhard v. *Salmon*, 249 N. Y. 458, 164 N. E. 545	11
Mississippi Publishing Corp. v. *Murphree*, 326 U. S. 438	13
National Labor Relations Board v. *Hearst*, 102 F. 2d 658	12
North American Co. v. *S.E.C.*, 327 U. S. 686	11
Park & Tilford v. *Schulte*, 160 F. 2d 984, certiorari denied, 332 U. S. 761	7, 10
Slaughter-house Cases, 83 U. S. 36	12
Smolowe v. *Delendo Corp.*, 136 F. 2d 231, certiorari denied, 320 U. S. 751	7, 8, 10
Steinberg v. *Sharpe*, 95 F. Supp. 32	7
United States v. *Caroline Products Co.*, 304 U. S. 144	11
Woods v. *City National Bank Co.*, 312 U. S. 262	10

Constitution and Statutes:

Act of June 10, 1930, 7 U.S.C., Section 499k	13
Act of August 24, 1937 (28 U.S.C. 2403)	1
Bankruptcy Act, Section 111 (11 U.S.C., Section 511)	12
Clayton Act, Section 12 (15 U.S.C. Section 22)	13
Communications Act of 1934, 47 U.S.C., Section 401	13
Constitution, Article IV, Section 2	11
Federal Power Act, Section 317 (16 U.S.C. 825p)	12
Investment Company Act of 1940 (15 U.S.C. Section 80a-43) Section 44	12

Constitution and Statutes—Continued

	Page
National Labor Relations Act, Section 11 (29 U.S.C., Section 161(5))	12
Natural Gas Act, Section 22 (15 U.S.C. Section 717u)	12
Packers and Stockyards Acts, 1921, 7 U.S.C., Section 217	13
Public Utility Holding Company Act of 1935 (15 U.S.C. Section 79y), Section 25	12
Securities Act of 1933 (15 U.S.C. 77v(a), Section 22(a)	12
Securities Exchange Act of 1934 (48 Stat. 881, 15 U.S.C. 78a, *et seq.*):	
Section 2	10
Section 16(b)	3, 5, 6, 7, 10
Section 27	4, 8, 9, 11, 12
Shipping Act, 1916, as amended (46 U.S.C. Section 830)	13
Trust Indenture Act of 1939 (15 U.S.C. Section 77vvv), Section 322	12
Urgent Deficiencies Act, 28 U.S.C. Section 44	12

Miscellaneous:

Federal Rules of Civil Procedure, Rule 4(f)	13
Stock Exchange Practice Hearings, 73rd Cong., 2nd Sess., p. 7742	11

In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 609

EDWARD N. CLAUGHTON, PETITIONER

v.

STELLA GRATZ, SUING AS STOCKHOLDER IN THE NAME AND BEHALF OF MISSOURI-KANSAS-TEXAS RAILROAD

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

In response to a certificate issued by the District Court for the Southern District of New York under the Act of August 24, 1937 (28 U.S.C. 2403), that the constitutionality of an act of Congress was drawn in question, the United States intervened to defend the constitutionality of Sections 16(b) and 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78p(b), 78aa) (R. 2). The Securities and Exchange Commission, which administers the Act, participated below as *amicus curiae* on the ques-

tions of construction of the Act raised in the proceedings. The views expressed in this brief are presented on behalf of the United States and the Commission.

OPINIONS BELOW

The opinions of the District Court (R. 23, 60, 61) have not been reported. The opinion of the Court of Appeals (R. 82-90) is reported at 187 F. 2d 46.

JURISDICTION

The judgment of the Court of Appeals was entered on February 6, 1951 (R. 90). The petition for a writ of certiorari was filed on March 14, 1951. The jurisdiction of this Court is invoked under 28 U.S.C. 1254, and Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78aa).

QUESTIONS PRESENTED

1. Whether the profit realized from trading in violation of Section 16(b) of the Securities Exchange Act may be computed by subtracting the lowest purchases from the highest sales within a six months rather than a three months period.

2. Whether Section 27 of the Securities Exchange Act permits an action under Section 16(b) of the Act to be brought in the place where the transaction giving rise to the liability occurred.

3. Whether Section 16(b) of the Securities Exchange Act, which allows suit to be brought in any court of competent jurisdiction to recover profits realized by one holding more than ten percent of

any class of any equity security registered on a national securities exchange from any purchase and sale of any equity security of the issuer of such security within a period of less than six months, is constitutional.

4. Whether Section 27 of the Securities Exchange Act, which permits such suits to be brought in the district court where the transaction constituting the violation occurred, and which permits process to be served in any other district of which the defendant is an inhabitant or in which he may be found, is constitutional.

STATUTE INVOLVED

Section 16(b) of the Securities Exchange Act of 1934 (48 Stat. 896, 15 U.S.C. 78p(b)) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a

period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Section 27 of the Securities Exchange Act of 1934 (48 Stat. 902, 15 U.S.C. 78aa) provides:

The district courts of the United States, the Supreme Court of the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction

constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

STATEMENT

This suit was instituted by Stella Gratz, a stockholder in the Missouri-Kansas-Texas Railroad Company on April 4, 1946, pursuant to Section 16(b) of the Securities Exchange Act, to recover profits realized by petitioner from transactions of purchase and sale within six months in the common stock of the railroad company. This stock was registered on the New York Stock Exchange, a national securities exchange, and all of the transactions are alleged to have taken place on that exchange.

In the district court, petitioner sought to have the action dismissed on the grounds, *inter alia,*

that venue had been improperly laid and that the Act was unconstitutional. The motion to dismiss was denied and summary judgment granted plaintiff. (R. 23-28.)

The matter was then referred to a special master, who took evidence on the question of damages, and concluded that petitioner was accountable for transactions entered into between December 18, 1944 and December 3, 1947, and calculated the profits to be $308,417.50. (R. 42-59.) The report of the special master was duly confirmed and judgment was entered for that amount. (R. 60-63.)

On appeal from both the refusal to dismiss the action and the final determination of damages, the Court of Appeals for the Second Circuit affirmed. (R. 82-90.)

ARGUMENT

Generally speaking, the Securities Exchange Act is designed to insure a fair and honest market which will reflect an evaluation of securities in the light of all available and pertinent data. Section 16(b) implements this general policy by making it unprofitable for officers, directors or large stockholders to engage in short-swing speculations on the basis of advance information not available to the investing public.

Liability under the section is based upon the profit realized by insiders from "any purchase and sale, or any sale and purchase" within a six months period. Thus, the Act aims at removing the

temptation to faithlessness by eliminating the possibility of profit by insiders from short-term speculation in their companies' securities.

1. We believe the court below correctly held, in accordance with all of the cases thus far decided under Section 16(b), that the liability imposed by that section should be based upon the difference between the lowest price paid and the highest price for which a like amount of securities was sold within six months.[1] Any other method would permit easy evasion and open the statute to the very abuses at which it was aimed.

The income tax method of calculating profits for which petitioner contends, while suitable where there are no time limitations within which the purchases and sales must occur, would permit any insider with a portfolio of his company's securities to trade at will without incurring any liability. He need only deliver securities held in his portfolio for more than six months to avoid the effect of Section 16(b). The only effective rule for the computation of profits recoverable under a statute aimed at depriving fiduciaries of any

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[1] *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (C.A. 2), certiorari denied, 320 U.S. 751, is the only reported case which discusses the measure of damages under Section 16(b). However, all Section 16(b) cases decided since that decision, both reported and unreported, have accepted the measure of damages there applied. See, *e.g.*, *Park & Tilford* v. *Schulte*, 160 F. 2d 984 (C.A. 2), certiorari denied, 332 U.S. 761; *Steinberg* v. *Sharpe*, 95 F. Supp. 32 (S.D.N.Y.).

possibility of profit must be one which, as the court below stated in an earlier case, is able to "squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."[2] Even if such a method should result in causing the insider who disobeys the section to sustain a loss within the meaning of the taxing statutes, there is no reason why the recovery should be minimized. On the contrary, to do so would defeat the salutary purpose of the statute.

The taxing statutes and the securities laws have radically different objectives and the taxing statutes are not limited, in their effect, to profits realized within six months.[3]

2. Venue, under the Securities Exchange Act, is governed by Section 27, which provides in pertinent part that:

> Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty

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[2] *Smolowe et al.* v. *Delendo Corp.*, 136 F. 2d 231, 239 (C.A. 2).

[3] Petitioner also contends that even if the income tax formula for the computation of profits is rejected, the highest sale price (or lowest purchase price) must be matched against the lowest purchase price (or highest sale price) within *three* months instead of six months. (Brief, pp. 27-30.) We find no statutory warrant for such a reduction in the period of time during which the insider is prohibited from trading.

> created by this title . . . may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business.

The court below concluded that Section 27 was intended to designate, for all civil suits to enforce a liability or duty created by the statute, a venue determinable without reference to the location of the defendant, and that there was no basis for distinguishing between civil liability for action designated as "unlawful", or which might constitute a crime, and other civil liability. It construed the "act or transaction constituting the violation" as including contravention of statutory policy which gives rise to statutory liability. Petitioner urges that the words "act or transaction constituting the violation" used in Section 27 "obviously refer to an unlawful act or transaction" (Brief, p. 21) and do not authorize the commencement of an action to enforce a purely civil liability in the place where the transaction giving rise to the civil liability occurred.

We agree with the court below that there is nothing in the text or policy of the statute to warrant such a restrictive interpretation of Section 27. There can be no question, here, that the suit is based upon action within the Southern District of New York in violation of the statutory policy against short term insider trading. It is clear from the legislative history of the statute and by

specific reference to the statutory purpose set forth in Section 2 that the Securities Exchange Act was designed primarily "to insure the maintenance of fair and honest markets." In order to accomplish this purpose the "transactions by officers, directors, and principal security holders"[4] were made one of the principal subjects of regulation. Viewed in this light it is plain that the pertinent "violation" of Section 16(b) takes place where the in and out trading occurs, in this case on the New York Stock Exchange.

3. There is no merit in petitioner's argument that Sections 16(b) and 27 are unconstitutional. Twice before the constitutionality of Section 16(b) has been attacked on substantially similar grounds and in both instances the Court of Appeals has rejected these contentions and this Court has refused certiorari. *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (C.A. 2), certiorari denied, 320 U.S. 751; *Park & Tilford* v. *Schulte,* 160 F. 2d 984 (C.A. 2), certiorari denied, 332 U.S. 761.

Section 16(b) was adopted by Congress only after an extensive investigation into the abuses of inside speculation. As a device to deter insiders from speculating in their knowledge of the corporation's affairs, the section is but a statutory application of basic common law principles which have long been accepted by the courts in comparable situations. Cf. *Woods* v. *City National Bank Co.,*

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[4] Section 2.

312 U.S. 262; *Meinhard* v. *Salmon*, 249 N.Y. 458, 164 N.E. 545. As the court below held, the section is a reasonable legislative restriction upon the evil sought to be prevented. Accordingly, it cannot be stricken down as in violation of the requirements of fundamental fairness.

Petitioner's contention that it is unreasonable to consider a ten percent stockholder an insider specifically contradicts the findings of Congress as expressed in the statute. Indeed, it was conceded at the hearings on the bill that less than one percent ownership might, in some instances, vest control over the enterprise.[5] Even assuming that it cannot be proved that petitioner, in fact, controls the railroad, the application of a general statutory prohibition cannot be avoided by seeking to show that the evil giving rise to the legislation is absent in the particular case. *North American Co.* v. *S.E.C.*, 327 U.S. 686; *United States* v. *Carolene Products Co.*, 304 U.S. 144.

4. Similarly, it has long been settled that federal legislative provisions similar to Section 27 of the Securities Exchange Act do not involve any unconstitutional exercise of power.

In the first place, the privileges and immunities clause of Article IV, Section 2, of the Federal Constitution, upon which petitioner relies, is solely a limitation on state power, not that of the federal

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[5] Stock Exchange Practice Hearings, 73rd Cong., 2nd Sess., p. 7742.

government. *Hague* v. *C.I.O.*, 307 U.S. 496, 511; *Slaughter-house Cases*, 83 U.S. 36, 76-77. In the second place, under this section of the Act citizens of New York do not have any greater privilege or immunity against suit in some other state than petitioner, who is a citizen of Florida.

Nor does Section 27 involve a deprivation of property without due process of law contrary to the Fifth Amendment. Similar provisions appear in Section 22(a) of the Securities Act of 1933 (15 U.S.C., Section 77v(a)), Section 11 of the National Labor Relations Act (29 U.S.C., Section 161 (5)) and Section 111 of the Bankruptcy Act (11 U.S.C., Section 511). Each of these sections has been construed to permit service of process outside the jurisdiction of the district court in which the action was being pursued. *Cohen* v. *Saddlemire*, 26 F. Supp. 27 (D. Mass.); *National Labor Relations Board* v. *Hearst*, 102 F. 2d 658, 662 (C.A. 9); *Continental Illinois National Bank & Trust Co.* v. *Chicago, Rock Island & Pacific Ry. Co.*, 294 U.S. 648, 683; *Mar-Tex Realization Corp.* v. *Wolfson*, 145 F. 2d 360, 362-363 (C.A. 2).[6]

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[6] In addition to the Acts cited above, the following statutes also provide for the service of process wherever the defendant resides or may be found. Public Utility Holding Company Act of 1935, Section 25, 15 U.S.C. Section 79y; Trust Indenture Act of 1939, Section 322, 15 U.S.C. Section 77vvv; Investment Company Act of 1940, Section 44, 15 U.S.C. Section 80a-43; Federal Power Act, Section 317, 16 U.S.C. 825p; Natural Gas Act, Section 22, 15 U.S.C. Section 717u; Urgent Deficiencies Act, relating to suits to enforce or set aside orders of the Interstate Commerce Commission, 28 U.S.C. Section 44,

More recently this Court has had occasion to state the following in connection with a decision construing the validity of Rule 4(f) of the Federal Rules of Civil Procedure, which refers to the service of process outside the territorial limits of the state in which the district court is held when a statute so provides (*Mississippi Publishing Corp.* v. *Murphree,* 326 U.S. 438, 442 (1946)):

> Had Congress specifically authorized service there [in a district other than where suit was brought] . . . petitioner would have been properly brought before the district court for the purposes of the present suit, since *Congress could provide for service of process anywhere in the United States.* [Italics supplied.]

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and incorporated by reference in the acts relating to the Federal Communications Commission, 47 U.S.C. Section 401, the Secretary of Agriculture, 7 U.S.C. Section 217, Section 499k, and the Maritime Commission, 46 U.S.C. Section 830. In addition, any suit under the anti-trusts laws "may be brought not only in the judicial district whereof [the corporation] is an inhabitant, but also in any district wherein it may be found or transacts business; and all process in such cases may be served in the district of which it is an inhabitant, or wherever it may be found," 15 U.S.C. Section 22.

CONCLUSION

The decision below is correct; there is no conflict of decisions; and no question warranting review is presented. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1951

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